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E.O. 12958: DECL: 05/21/2017
TAGS: EFIN ECON PREL KU
SUBJECT: KUWAIT DROPS DOLLAR PEG, RETURNS TO BASKET

REF: KUWAIT 184

Classified By: Ambassador Richard LeBaron for reasons 1.4 (b) and (d).

¶1. (C/NF) Summary: On May 20, Kuwait's Cabinet approved a decision to abandon the U.S. dollar peg for a basket of undisclosed currencies, which will be dominated by the dollar. Although the decision followed months of speculation on the wisdom of the peg, the timing appears to have surprised regional markets. Central Bank Governor Shaykh Salem Abdulaziz Al-Sabah told Kuwait's official news agency that the decision had been made because of the "detrimental effects of the pegging system to the national economy." Central Bank Deputy Governor Dr. Nabil Al-Mannaei maintains that this decision will have a negligible impact on the dollar while allowing Kuwait greater monetary policy control. He assured Econoff that "the GOK remains committed to the formation of the GCC Monetary Union" and will continue to make the required economic and legislative changes to ensure its success. End summary.

CBK: Dollar Peg Was Disappointing

¶2. (C/NF) On May 20, Kuwait decided to remove its currency peg to the dollar ending months of speculation about the wisdom of such a peg given the dollar's continued slide. The Central Bank of Kuwait immediately replaced the dollar peg with a basket of undisclosed currencies for the first time since January 2003. Press reports indicate that the dollar will likely represent 75-80 percent of the new basket of currencies. "The basket would typically mean the euro, sterling, Swiss franc and the dollar,'" noted National Bank of Kuwait's Treasury Department Head Mazen Al-Nahedh to Reuters.

¶3. (C/NF) Central Bank Deputy Governor Nabil Al-Mannaie told Econoff May 21, however, that the basket remains "undisclosed" and figures bandied about in the press are speculation only. He noted that the U.S. dollar will still be the dominant currency in the basket. Al-Mannaei insisted that there was no particular significance to the timing of the decision; rather the GOK had been considering this course of action for some time and recently completed an internal policy review on how best to proceed. In the end, the primary reasons for taking this decision were CBK's desire to use the exchange rate as a monetary instrument to try to curb inflation. Al-Mannaei believed the move will have negligible impact on the dollar but will greatly increase CBK's ability to absorb sharp fluctuations in the market.

CBK: Kuwait Remains Committed to the GCC Monetary Union

¶4. (C/NF) Turning to the GCC Monetary Union, Al-Mannaei stressed that as reflected in CBK's May 20 press release, "The GOK is fully committed to a single currency." Kuwait will continue to participate in regional efforts to achieve this union including the required economic conversions and legislative changes. Waving aside press reports of regional markets' surprise at the sudden announcement, he noted that central banks do not typically give advance notice of policy decisions. There were, however, a series of independent reports from leading financial firms speculating that such a change was on the horizon. He concluded by reiterating that this decision "does not mean that Kuwait is moving away from the dollar." (Comment: Kuwait's decision potentially undermines the timely formation of the GCC Monetary Union by shifting focus from the goal of a single currency. Domestic pressures may force GCC members to explore similar baskets, diverting their attention from the economic and legal reforms required to achieve a unified currency. End comment.)

GOK Officials Warned of Misgivings

¶5. (C/NF) CBK Governor Al-Sabah and Minister of Finance Bader Al-Humaidhi expressed their misgivings about the decision to peg the dinar to the dollar during the January 2007 visit to Kuwait by U.S. Treasury and Federal Reserve (ref A). Citing record high levels of inflation and concerns about the dollar's downturn, Al-Humaidhi indicated that Kuwait would consider returning to a basket of currencies if it appeared that the ambitious 2010 target for the GCC Monetary Union would be delayed.

Reactions from the Banking Sector

¶6. (C/NF) The Ambassador spoke with heads of major Kuwaiti banks on May 21 to seek their assessments of the revaluation and de-link from the dollar:

-- Commercial Bank of Kuwait head Abdulmajid Al-Shatti attributed the move to pressure from the parliament to take steps to alleviate inflationary pressures. Al-Shatti contended that this step was taken partly to deflect other demands from the National Assembly members, such as forgiveness of consumer debt. He said the other reason for the change was that "we don't know where the dollar is heading." He doubted that there would be huge initial impact, speculating that the dollar would weigh more than seventy percent in the basket given Kuwait's dependence on the dollar in its oil trade. Regarding the move's impact on plans for GCC monetary integration, Al-Shatti opined that this was "not working anyway, so Kuwait wanted to mitigate the effects (of the weak dollar) on its economy." He sees nothing happening on the monetary union until at least 2010, primarily because of the gap between the oil-rich GCC members and those without -- Bahrain and Oman.

-- Gulf Bank Chief General Manager Louis Myers said the revaluation was not unexpected and had been on the screens of the Central Bank for some time. He also interpreted it as a move to help deflect rising inflation, which he put at five percent, with about thirty percent of Kuwaiti imports denominated in dollars. Although it was still early days, he did not expect major pressure to revaluate further, noting that the currency had only moved three-tenths of a percent so far.

-- National Bank of Kuwait CEO Ibrahim Dabdoub told the Ambassador that the Head of the Central Bank had wanted to re-gain the exchange rate tool for some time. (It was lost in 2003 when GCC countries agreed to try to move toward a common monetary system; as noted, Kuwait previously used a

basket.) Dabdoub said that the CBK Chairman was frustrated because he had only the less effective interest rate tool to use to manage monetary policy. Dabdoub did not think there would be pressure from the market to further revaluate the dinar against the dollar. Although he said he was in the minority, he thought the dollar would not weaken too much more internationally.

-- Citigroup Country Officer and General Manager Raj Dvivedi expressed little surprise at the move, noting that the shift should have been more substantial to reflect the dollar's weakness. Citigroup Deputy General Manager Hazem Al-Eisa attributed the decision to the GOK's unhappiness with the delay in the formation of the GCC Monetary Union. Nevertheless, he noted that the dollar will remain a key part of the Kuwaiti economy because most imports are dollar-based, and the basket will reflect this trading pattern.

¶7. (C/NF) HSBC Director of Investment Banking Peter Thomas told Econoff that the decision would have little short-term impact on HSBC operations as the bank's capital is held in U.S. dollars and not dinar. He noted that, in his opinion, the decision appeared to be an affront to the U.S. because Kuwait owes so much to the U.S., and this will have a negative affect on the U.S. economy. The timing of the decision was also surprising because Wall Street appears to be doing well, despite troubles in the housing market, he added.

LeBaron